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C O N F I D E N T I A L SECTION 01 OF 03 RIYADH 001508

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SUBJECT: SAUDI ARABIA LOOKING TO EXPAND CORPORATE FINANCE
OPTIONS

REF: A. 08 RIYADH 1325

[1](#)B. RIYADH 1472

Classified By: Deputy Chief of Mission Susan L. Ziadeh for reasons 1.4
(b) and (d)

Summary

[1](#)1. (C) The Capital Markets Authority (CMA) is working hard to develop the Saudi corporate bond market, an endeavor it started in June 2009 by enhancing investment banks' understanding of how the market works. The CMA does not see a benchmark set by a series of government debt issuances as necessary for the development of the market, but would like to see more large Saudi companies, such as Aramco, participating. The Finance Ministry says it will not be issuing more debt soon, and that the market will develop as investors and companies become more comfortable with issuing debt instruments. On the other hand, the private sector would like to see government issuances, as well as the creation of a local rating agency, but some companies have indicated these are not necessarily prerequisites for their participation. The CMA is looking at ways to increase international participation in the stock market, possibly by altering the current definition of a swap agreement. End summary.

Capital Markets Authority Upbeat on Bond Market

[1](#)2. (C) Econoff met November 3 with Yasser Al-Rumayyan, Director of Corporate Finance at the CMA, to discuss the development of Saudi Arabia's corporate bond market and what it means for corporate finance in the Kingdom. Al-Rumayyan described the bond market, launched in June 2009, as in its early stages of development. He said the regulatory framework exists for companies to issue both traditional corporate bonds and Islamic sukuk, which are similar to corporate bonds but are attached to specific projects or revenue streams and thus have a variable rate of return (thus incorporating the Shari'a requirement that any investment have an appropriate level of risk associated with it). To date, there have only been five issuances by two companies: three by the parastatal petrochemical giant SABIC and two by the parastatal power company, the Saudi Electricity Company (SEC). All five issuances were Islamic sukuk, with SABIC's issuances each tied to the future earnings of one of its subcomponents, and SEC's issuances tied to future collections of electricity fees and of connectivity fees (fees for connecting to the electricity grid).

¶3. (C) Al-Rumayyan maintained that the CMA is encouraging companies to take advantage of the bond market by fast-tracking applications, but that there is only one investment bank in Riyadh (HSBC) with the expertise to advise its clients on how to issue a sukuk or bond (Note: According to HSBC CEO Walid Khoury, the other international investment banks also have the necessary expertise. End note.). The CMA is planning to address this lack of expertise by educating other investment banks in the requirements and process for issuance, and is planning a conference to this end for early 2010. He also said the CMA hopes large issuances by big Saudi firms, such as Aramco, will boost the level of activity on the market. Al-Rumayyan does not believe it was important for the government to issue new debt and thus establish a benchmark for the private sector. If Aramco issued sukuk, it would bring far more companies into the market than if the government were to do so, according to Rumayyan.

¶4. (C) On October 31, Vice Minister of Finance Hamad Al-Bazai emphasized that the necessary legal framework was in place and he hoped additional companies would participate; but the government has no intention of issuing new debt in the near future. He said that, as with many institutions, it will take time for investors and issuers to become "comfortable" with the Saudi bond market.

Private Bankers Disagree, Seek a Government Benchmark

¶5. (C) Challenging the position of Saudi government finance

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officials, private commercial and investment bankers encourage the government to issue debt, preferably in 2-year, 5-year, and 10-year increments, to set a benchmark yield curve for the bond market. Without this benchmark, the market will continue to see only a few issuances, mostly by large parastatals, and with few transactions (currently the secondary bond market often goes days without a single trade). Bankers, including those working for Riyadh Bank and the Saudi Investment Bank, told Econoff the domestic banks are awash with cash and looking for somewhere safe to put it (over the past several months, overnight bank deposits at the central bank have hovered around 70 billion Saudi riyals -- the equivalent of \$18.7 billion -- and up from less than one billion riyals in mid-2008). One banker disagreed with the CMA's characterization of its efforts to facilitate more issuances, saying it has been placing unnecessary bureaucratic impediments in the way of increased participation.

¶6. (C) In a recent article in the English daily Arab News, Kamal Mian, the head of Saudi Hollandi Bank's Islamic banking unit, said the bond market needs a government issuance not just as a benchmark for pricing, but also to act as an anchor investment. Mian also said Saudi Arabia also needs a local rating agency as the "high financial cost" of ratings from the international agencies was limiting interest. HSBC echoed this assessment, noting that the lack of a rating would force banks to dedicate higher reserves to offset the greater risk associated with unrated liabilities, reducing their returns.

¶7. (C) Senior officers of the Olayan Financing Company said they would consider issuing sukuk before the establishment of a government benchmark. They added that the corporate bond market could be useful as a tool to extend the life of their debt, which is currently limited by the short maturities offered by Saudi banks.

CMA Also Looking to Expand Equities Market

¶8. (C) Dr. Fahad Al-Mubarak, chairman of the Tadawul (the Saudi stock market), told Econcouns on October 27 that he

would like to see 300 companies listed (there are currently around 130). He would also like to open up the market to more international investors in order to reduce volatility and improve corporate transparency. Al-Mubarak suggested inviting pre-qualified international investors to participate as a possible first step in this process.

¶9. (C) On the other hand, Al-Rumayyan views pre-qualification as a step backward as there is no similar requirement for either Saudi or GCC investors (who can currently fully participate in the market). He said the CMA is working on enhancing the swap agreements through which international investors can currently participate in the equity market (ref A). According to Al-Rumayyan, one of the chief reasons international investors have been hesitant to take advantage of the swap agreements is that shares that are purchased for these investors are actually held by an investment bank in Saudi Arabia. In the event that bank goes bankrupt, the overseas investor could lose his investment. Al-Rumayyan said the CMA is addressing this counterparty risk by writing into the swap agreements that, in the event of an investment bank going bankrupt, shares it holds as part of a swap agreement would be dealt with separately from the bankruptcy settlement.

¶10. (C) Al-Rumayyan said the second way the CMA sought to increase participation in the stock market, particularly among institutional investors, is by increasing the use of mutual funds. Several funds currently exist, but they hold less than two percent of the market's capitalization. He would like to see private pension funds, such as Aramco's pension fund, involved with Saudi mutual funds.

Comment

¶11. (C) The choices the SAG makes on how to develop its capital markets will have a significant impact on the rate and scope of the economy's growth, and on the role of the private sector. While the SAG clearly has big plans for the

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future of both the corporate bond market and the equity market, the public and private sectors hold diverging views regarding the best way to create momentum and scale. There are still several important steps the Kingdom needs to take before its bond market becomes a serious source of finance, including the establishment of a benchmark (whether through government participation or the participation of another sizeable actor -- such as Aramco), an increase in the expertise of local investment banks on bond and sukuk issuances, and the establishment of a local rating agency (or a greater willingness by local companies to seek ratings from international agencies). Clear bankruptcy laws would also increase investor confidence.

¶12. (C) On the stock market, it is unlikely anything short of allowing direct participation in the market will entice significant international investment. The CMA's efforts to enhance the current swap agreement system are unlikely to assuage the concerns of international investors, particularly given the recent perception that domestic banks were favored over international banks in a major commercial dispute (ref B).
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